

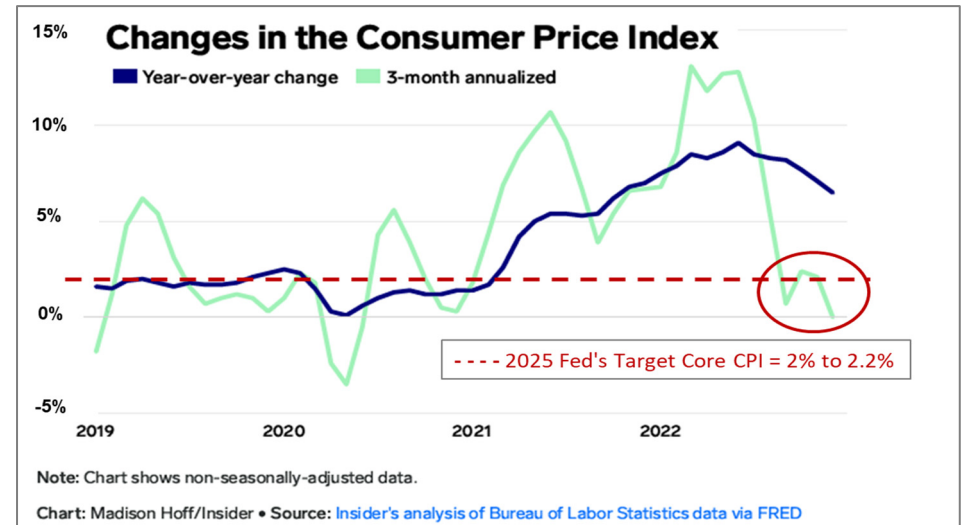
From: Aequitas Investment Advisors

Warner
Spencer

Re: Maybe We'll Have a Soft Landing After All

As we enter the new year, there is no shortage of predictions about the future given the various risks from both economic and geopolitical perspectives. The investment markets appear to be primarily focused on whether or not the Federal Reserve can successfully engineer a *Soft Landing* as it attempts to bring down inflation while not tanking the economy. By that measure, paradoxically, good economic news might be negative for the stock market and vice versa. For example, one recent headline from MarketWatch read, *Dow Up Nearly 400 Points as Pace of Jobs Growth, Wage Gains Cool*. Such an indication that the economy is cooling rather than sinking is a favorable sign that the Fed's policies might be working. On the other hand, a few days earlier, a headline from CNN read, *Dow Sinks More than 300 Points on Strong Jobs Reports*. One might think that more jobs, or at least a strong jobs market, might be good for stocks. While that is vitally true for the economy and stock market over the long run, given the Fed's current inflation fighting priority, the investment markets are looking for signs of receding inflation which might require some weakening in the employment picture, but not enough to cause a serious recession, i.e., a *Hard Landing*. On that score, according to the most recent CPI figures released by the U.S. Bureau of Labor Statistics, inflation appears to be heading in the right direction which is supportive of the *Soft Landing* scenario. In the graph to the upper right, based upon 3-month annualized data, inflation has cooled off significantly in recent months and has fallen below the Federal Reserve's 2025 target range of 2% to 2.2%. While the year-over-year change in inflation remains well above the Fed's target range, it appears to be heading downward. The encouraging news about inflation over the past few months is a big reason why the stock market has rebounded over the past three months.

The favorable *Soft Landing* scenario does not necessarily mean that the economy would avoid falling into recession. In fact, according to a recent Bloomberg poll of economists, 7 out of 10 are predicting the U.S. will experience a recession in 2023 (this might be a contrarian indicator based upon the track records of economists). Given this widely accepted belief we will experience a recession, it is probable that the investment markets have already priced in at least a mild recession. According to Mark Zandi, an economist at



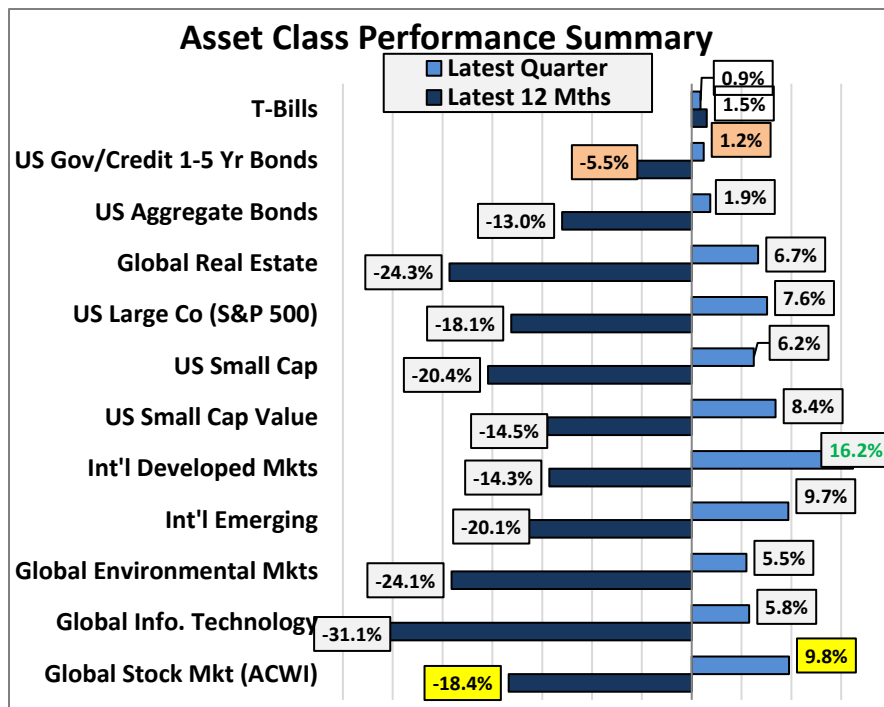
Moody's Analytics who was recently interviewed by Market Insider, "Usually recessions sneak up on us. CEOs never talk about recessions. Now it seems CEOs are falling over themselves to say we're falling into recession.....Every person on TV says recession. Every economist says recession. I've never seen anything like it." So while a mild recession may come as no surprise, what would surprise the markets, on the other hand, might be a sudden acceleration in inflation, or a more severe economic downturn than expected. Of course, there are the ever-present political, geopolitical and climate event risks which could also undermine what appears to be a relatively positive economic outlook.

A major factor supporting the *Soft Landing* scenario is the underlying strength of the labor market and the systemic shortage of workers. Recessions are normally accompanied by layoffs and high unemployment, but given the shortage of workers, the argument goes, there may be fewer layoffs than in past economic downturns. In addition to the strong jobs market, other factors supporting the *Soft Landing* scenario include the fact that household and corporate balance sheets are both healthy, and the banking system is well capitalized. And given the advance warnings of an economic slowdown, corporations have been preparing by putting recession plans in place and delaying or avoiding major capital projects.

An alternative to the *Soft Landing* scenario is one suggested by Liz Ann Sonders, Chief Investment Strategist at Charles Schwab. Liz Ann doesn't believe there will be a recession later this year because she suggests we are already in a recession. By that she argues we've been in a *Rolling Recession* since the first half of 2022 when the U.S. economy experienced two consecutive quarters of negative GDP growth. A *Rolling Recession* is one where various sectors of the economy have slowdowns in a rolling manner rather than the entire economy falling into recession at once. Sectors which are or have been in contraction include the housing sector, certain consumer goods sectors which have bloated inventories, the auto sector, and to some extent the technology sector which has been laying off workers over the past few months. Underlying the *Rolling Recession* argument is that there are compensating strengths in other sectors and in the jobs market which might prevent the entire economy from entering a recession.

Asset Class Performance Review (What a Great Fourth Quarter for a Change!)

The turnaround in market sentiment is clearly seen in the robust returns during the fourth quarter of 2022 as the Global Stock Market advanced by close to 10%. Many of the asset classes which have been lagging over the past few years led the way, highlighted by International Developed Markets stocks which

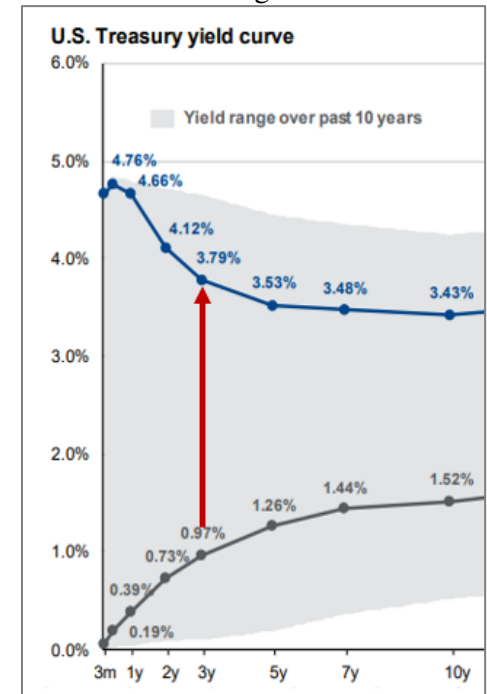


gained 16.2% (this return was magnified by the falling U.S. Dollar which lost about 11% against the Euro during the quarter – a trend some suggest may continue for a while). Emerging Markets and U.S. Small Cap Value stocks were next in line with returns of 9.7% and 8.4% respectively. The range of returns of the other stock asset classes was between 5.5% (Environmental Markets) and 7.6% (U.S. Large Companies). Bonds also made a comeback with the longer-term U.S. Aggregate Bond Index gaining 1.9%, Short-Term Bonds rose by 1.2% and T-Bills gained close to 1%. The healthy returns for the fourth quarter provided a welcome ray of sunshine in an otherwise dismal year (and provided a reminder of the importance of maintaining a long-term view).

For the calendar year, the Global Stock Market declined by 18.4% making this the worst year since the 2008 financial crisis when the benchmark fell by 42%. Combined with the negative 13% return on the U.S. Aggregate Bond Index, 2022 was the first time on record when both stocks and longer-term bonds both declined by double digits. This is not the sort of record investors want to experience. Once the Fed began hiking rates to combat inflation, bond prices began to plummet, and stock prices sank as the era of “easy money” came to an end. Leading the way downward last year were Global Information Technology stocks (-31.1%) followed by Global Real Estate (-24.3%), Global Environmental Markets (-24.1%), U.S Small Cap stocks (-20.4%) and Emerging Markets (-20.1%). Returns for the other stock asset classes ranged from -18.1% (U.S. Large Cap stocks) to -14.3% (Int'l Developed Markets). As mentioned previously, the U.S. Aggregate Bond Index fell by 13% and the shorter-term U.S. Gov't/Credit 1-5 Year Bond Index declined by 5.5%. The only asset class with a positive return in the summary chart was U.S. T-Bills (+1.5%). From an investment perspective, we can certainly say good riddance to 2022!

Lower Bond Prices = Higher Yields

While 2022 was painful, the drop in bond and stock prices sets us up, we believe, for a much brighter future over the next 5-10 years. Given the effect of the Fed's monetary tightening, i.e., raising interest rates to combat inflation, investors can now earn much higher



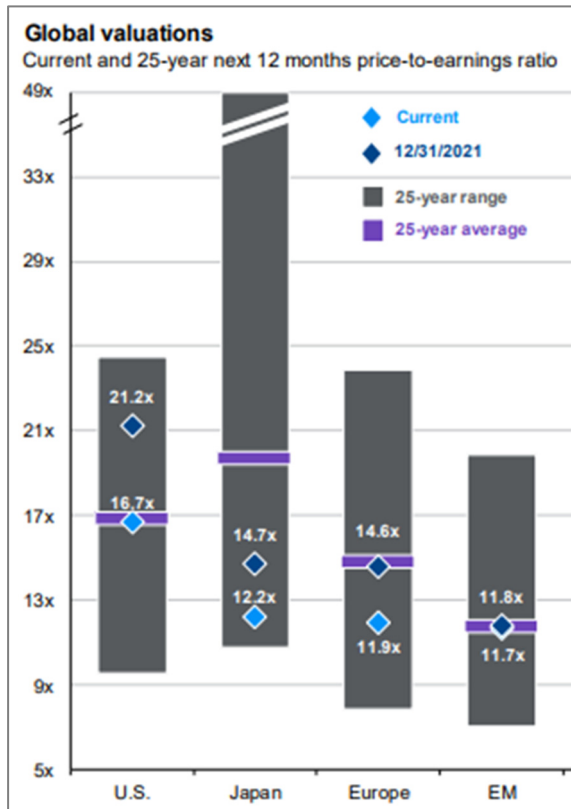
yields on the fixed income section of their portfolios than they could a year ago. In the U.S. Treasury Yield Curve chart on the previous page, note the gray line which indicates bond yields at various maturities as of December 31, 2021. A 3-year Treasury note was paying less than 1% a year ago compared to 3.8% as of early January. That represents close to a 300% increase in yield on the 3-year Treasury note! Yields on short-and intermediate-term high quality corporate bonds as of this writing were between 4.5% and 5.0%. These higher yields equate to higher expected future returns on bonds and bolster the benefits bonds which are to provide a safety net for investors, reduce overall portfolio volatility *and* provide favorable yields.

Lower Stock Valuations = Higher Expected Future Returns

Stock prices plummeted in 2022 largely due to the Federal Reserve’s rapid shift in monetary policy from accommodation to tightening in order to combat inflation. The pace of the Fed’s interest rate hikes was the fastest on record which exacerbated the meltdown. Stocks entered the year at record-high price

levels having benefited from ultra-low interest rates during the pandemic as well as massive government stimulus. However, those high stock prices became unsustainable as interest rates rose and the economy began to cool. Fast forward to the third quarter of 2022 at which point stocks in the U.S. and abroad had lost more than 25% of their value as the mood of investors shifted from greed to fear. Stocks rebounded somewhat by year-end, but were still down by about 18% from their record high a year earlier.

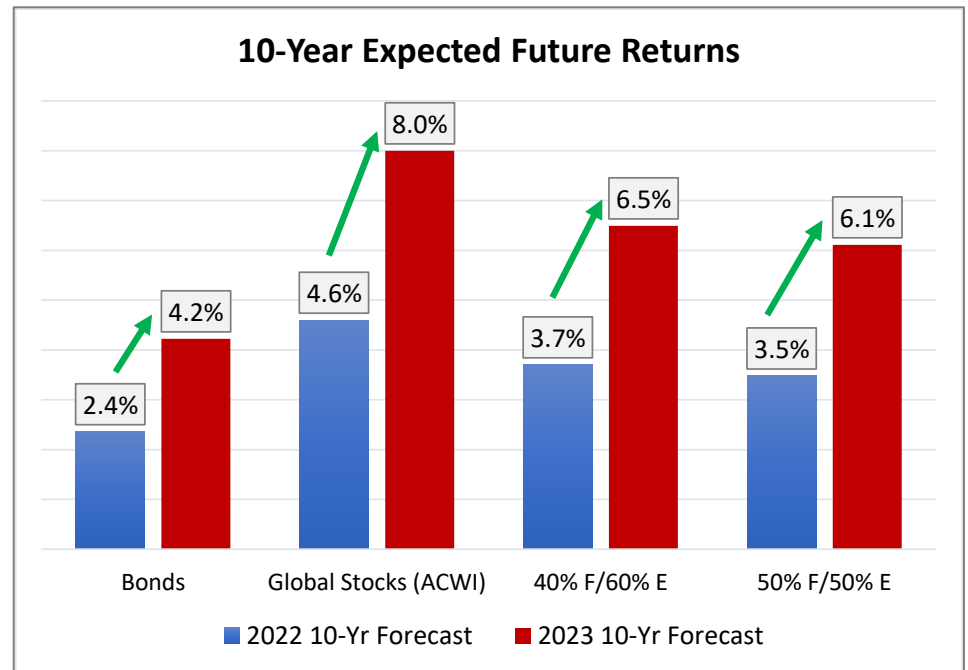
In the chart to the left, note the four gray bars representing major global stock market regions. The dark blue diamonds indicate the forward-looking Price-to-Earnings



Ratios at the end of 2021 while the light blue diamonds indicate current valuation levels. Note that the light blue diamonds are significantly lower than they were a year ago, with the exception of Emerging Markets which remain priced at their average valuation levels. The takeaway is that the stocks around the globe are now priced at average or below average valuation levels. In our view, this bodes well for the Global Stock Market and its performance over the next 10 years.

Putting the Two Together

With significantly higher bond yields and stocks priced at more attractive valuation levels, future expected returns are higher than they were a year ago. In the chart below, we compare the expected 10-year future returns from one year ago to current expectations. The expected return on bonds has risen from 2.4% to 4.2% given the higher yields currently available. We include the expected return on the Global Stock Market (MSCI ACWI) which is a highly diversified average of the expected returns on U.S. and foreign stocks. The current 10-year expected return for the Global Stock Market is 8% which is slightly lower than its average return over the past 20 years. For a balanced portfolio comprised of 40% in bonds and 60% in stocks, the expected return is 6.5% compared to a mere 3.7% one year ago. For a 50/50 mix of bonds and stocks, the expected return has jumped from 3.5% to 6.1%. (Note: the expected return estimates are a compilation of our research on the historic relationship between P/E Ratios based upon forward earnings estimates and subsequent 10-year returns, as well



as the most current Long-Term Capital Markets Assumptions published by J.P. Morgan and Research Affiliates.)

Our Investment Strategy

2022 was the fourth worst calendar year for a 40% bond and 60% stock portfolio since 1926 (1931, 1937 and 2008 were the only years with poorer returns). While seeing the value of our portfolios decline over the first three quarters of 2022 was painful, the good news is that bonds and stocks are now priced at levels which have the potential to deliver favorable returns in the future. We continue to believe that a globally balanced portfolio is an effective strategy for delivering desirable risk-adjusted returns over the long term. Looking forward, especially now that bonds are generating more attractive yields, the bond section of our clients' portfolios will continue to serve as a safe haven to not only provide liquidity for short and intermediate-term financial needs, but also as a portfolio diversifier to dampen the expected volatility of stocks. Furthermore, we mentioned in our Quarterly Markets Review emailed to clients recently, "our diversified, low-cost emphasis on smaller cap, value, and profitability using thousands of equity securities from all over the world, is one of the best ways to reduce volatility and maintain favorable risk-adjusted returns over the long term. In addition, our tilt toward sustainable, high-quality companies should continue to help our relative performance as energy prices normalize and corporate responsiveness to sustainable business practices is appropriately rewarded."

Some Predictions

While we suggest that the *Soft Landing* scenario is more likely given the underlying strengths in the economy and the downward direction of inflation, on the other hand, there is no shortage of predictions about how things might go wrong in 2023 given the wide array of challenges. We could choose to paint a pessimistic picture, but in our view, pessimism is not a successful long-term strategy either in life or investing. We believe that by allocating a substantial portion of one's portfolio to safe haven assets, such as high-quality bonds (especially now that they're paying a decent yield), one can cushion the blow of negative economic developments by providing the necessary liquidity to meet an investor's short and intermediate cash flow needs while riding out a potential financial storm. So while we don't discount the possibility of negative developments in the future, we believe that one's portfolio can be structured to deal with such possibilities. In other words, portfolios should be structured to allow for both favorable and unfavorable developments without the need for market timing or waiting until an "all clear" signal (which may never come).

Casey Stengel, the infamous baseball player and manager of the New York Yankees, once said, "Never make predictions, especially about the future." Despite that warning, but in the spirit of optimism, we offer a few predictions from two well-respected economists and investment strategists whom we have followed over our careers (these quotes appeared in a recent Markets Insider online post).

- Jeremy Siegel: "I've never seen so much bearishness. There's never been a time when 60% of economists forecast a recession. And when everyone's on one side, I get very wary. I think there might be some real surprises [in 2023]," Siegel said in a Bloomberg interview. "My projection is a 15% increase [in the stock market], and believe it or not... I think the first half might be the increase that surprises people, because the market is very forward-looking," he said.
- Ed Yardeni: "I think we made a low on October 12 in the market. I think that was the end of the bear market. And I think we're back in a bull market. Not straight up, a lot of volatility, but I think the markets are telling us the world economy is improving," Yardeni said in an interview Wednesday [January 11th] with Bloomberg. He based his view on factors including lower energy prices and China's reopening, which could boost stocks.

Closing Message

We close with some thoughts from travel journalist Colin Treadwell which were passed along to us by one of our clients. While one might wonder what traveling has to do with investing, we think you'll see some commonalities in Colin's message (and our nautical theme at Aequitas which involves charting a course to achieve one's future goals and making necessary adjustments along the way).

Yes, there will always be problems. But if you are putting off living fully until they all go away, you will be waiting a long time. This is our time, and I am so grateful to be alive.

That reminds me of a quote I love from Albert Einstein. "The most important decision we make is whether we believe we live in a friendly or hostile universe." I like that he frames it as a decision, whether to believe that the universe is friendly or hostile. Which one you believe will make a huge difference in how you feel about life. By calling it a decision, Einstein implied that the question is ultimately beyond the reach of human understanding. But as one who had studied atomic particles, and seen that

human observation affects what is being observed even on an atomic level, he seemed to have come to the conclusion that belief is itself a force.

Much good comes from challenges and struggles. Hard times produce some of our most precious moments. It's only in the face of troubles that human beings can achieve their most heroic acts, or experience their most profound emotions. As with any disaster, much good has come from the Covid pandemic. It may take a while to be able to see it. But it's there.

So I will not say goodbye and good riddance. Instead I bid a fond farewell to a precious part of my life. Goodbye 2022, and thank you! And welcome 2023. Happy New Year! I have a feeling it's going to be good.

